

Five Observations on Recent Use of Universal Proxies

By Tiffany Posil,¹ Counsel at Hogan Lovells US LLP*

On September 5, 2019, the SEC’s Investor Advisory Committee (“IAC”) approved a recommendation that the SEC adopt its proposed universal proxy rule with modest changes to address objections that have been raised to the proposed rule.² While it is too early to tell if the IAC’s recommendation will be the catalyst the SEC needs to dust off the universal proxy proposing release, the following observations from recent use of universal proxies may influence the approach the SEC ultimately takes to implement a universal proxy rule.

1. Views on whether universal proxy cards favor companies or dissidents have shifted. The recent use of universal proxy cards by companies like EQT Corporation and SandRidge Energy, Inc. has led to increased commentary on whether universal proxy cards create an advantage for companies or dissidents. Despite the historical position of most corporate advisors that universal proxy cards create an unfair advantage for dissidents, many are now acknowledging that universal proxy cards can be advantageous for the company in certain situations.³

In its definitive proxy statement, EQT characterized the use of a universal proxy card as a “best-in-class governance practice,”⁴ and SandRidge acknowledged in a press release that universal proxies provide shareholders with “flexibility and clarity regarding their votes in a contested election.”⁵

¹ Ms. Posil was a primary drafter of the Universal Proxy proposing release, Release No. 34-79164 (Oct. 26, 2016) (the “Proposing Release”).

² This recommendation was one of four specific recommendations addressing proxy plumbing that were adopted by the IAC during a telephonic meeting on September 5, 2019. See <https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-the-us-proxy-system-090519.pdf>. The modest changes proposed by the IAC include clarification regarding the presentation and format of the universal proxy card and a higher minimum solicitation threshold for dissidents.

³ See, e.g., MacKenzie Partners, Inc., *The Universal Proxy Gains Traction: Lessons from the 2018 Proxy Season*, available at <http://www.mackenziepartners.com/UniversalProxyWhitePaper.pdf> (discussing the situation in which a universal proxy can be a powerful strategic tool for management teams, particularly those whose odds of defeating all of a dissident’s nominees in a proxy contest for board control are uncertain and the situation in which a universal proxy can benefit management by disadvantaging the dissident). See also Claudia H. Allen, *Voting in proxy fights: You can’t always get what you want*, KPMG Board Leadership Center, available at <https://boardleadership.kpmg.us/content/dam/boardleadership/en/pdf/2019/voting-in-proxy-fights.pdf>.

⁴ See Definitive Proxy Statement on Schedule 14A filed by EQT Corporation on May 22, 2019.

⁵ See Exhibit 99.1 to Soliciting Material on Schedule 14A filed by SandRidge Energy, Inc. on May 7, 2018.

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2. **A nominee consent requirement imbedded in a company's advance notice bylaw, or the nominee questionnaire required by such bylaw, can create an uneven playing field and invite gamesmanship by the parties.** In a contested election, a party cannot include the other party's nominees on its proxy card unless the other party's nominees consent.⁶

Such consent is rarely provided voluntarily due to the contentious nature of proxy contests and concern that one party could gain a significant strategic advantage if allowed to include the other party's nominees on its proxy card. For that reason, universal proxy cards including the names of all company and dissident nominees are rarely used.

The SandRidge proxy contest highlighted that companies are able to preserve the optionality to use a universal proxy card by including a requirement in the company's advance notice bylaw, or in the nominee questionnaire required by such bylaw, that director nominees consent to being named in the company's proxy statement.⁷ While some commentators expressed disbelief that a company would include a nominee consent provision in a nominee questionnaire required by the advance notice bylaw, this tactic is not new.

Since dissidents do not have a similar ability to preserve the optionality to use a universal proxy card, and can only use a universal proxy if the company's nominees consent to being included on the dissident's proxy card, the company's nominee consent requirement can create an uneven playing field in a proxy contest and, in turn, invite gamesmanship by the parties.

In the SandRidge proxy contest, it appears that a nominee consent requirement in the nomination materials mandated by the company's advance notice bylaw gave SandRidge the ability to include Carl Icahn's nominees on the company's proxy card. Mr. Icahn did not have a similar ability to include the company's nominees on his proxy card.⁸

SandRidge did not name Mr. Icahn's nominees on the company's proxy card included with the preliminary proxy statement, but switched to a universal proxy card only after expanding the size of the board of directors to accommodate two independent nominees put forth by Mr. Icahn and, presumably, after realizing a universal proxy card could be advantageous for the company. According to SandRidge, Mr. Icahn engaged in his own form of gamesmanship by encouraging shareholders to reallocate their votes among the nominees on the universal proxy card to ensure that more Icahn nominees would be elected.⁹

3. **The strategic motivations of the parties will drive the presentation of nominees on universal proxy cards and may result in shareholders receiving two different universal proxy cards from the parties.** In the EQT proxy contest, EQT specifically requested that the dissident group ("Rice Group") use the same format for their universal proxy card as the company and list each of the company's nominees in alphabetical order.

While the Rice Group agreed to list the nominees in alphabetical order, its universal proxy card included a total of three columns of nominees with one column for the Rice Group nominees and

⁶ Exchange Act Rule 14a-4(d)(1) and (4).

⁷ See Definitive Revised Proxy Statement on Schedule 14A filed by SandRidge Energy, Inc. on May 15, 2018 (disclosing that each of Mr. Icahn's nominees consented to be named as a nominee in the company's proxy statement in the nomination notice delivered pursuant to the company's advance notice bylaw). Notably, the dissidents in the EQT and Rent-A-Center, Inc. proxy contests each filed a lawsuit challenging a nominee consent requirement included in a nominee questionnaire required by the subject company's advance notice bylaw. See Soliciting Material on Schedule 14A filed by the Rice Group on April 25, 2019 (disclosing that Toby Rice filed a lawsuit in Pennsylvania State Court against EQT seeking, among other things, to prevent EQT from using the consent required pursuant to the nominee questionnaire to name any of the Rice Group nominees in EQT's proxy statement); *Engaged Capital Flagship Mater Fund, LP v. Rent-A-Center, Inc.*, C.A. No. 2017-0165-JRS (Del. Ch. Mar. 6, 2017) (Engaged Capital sought an order prohibiting Rent-A-Center from including Engaged Capital's nominees in the company's proxy statement pursuant to a consent requirement included in the nominee questionnaire required by the company's advance notice bylaw).

⁸ In this contest, Mr. Icahn proposed a full slate of nominees. If he had instead proposed a minority slate, he would have had the ability to round out his slate with company nominees pursuant to Rule 14a-4(d)(4). This rule permits a dissident seeking to elect a minority of the board to solicit authority to vote for some of the company's nominees on its proxy card, but the dissident is only permitted to include on its proxy card the names of the company nominees for whom it will not vote.

⁹ See Exhibit 99.1 to the Form 8-K filed by SandRidge Energy, Inc. on June 18, 2018. Mr. Icahn disputed the company's claims in this regard and ultimately won four board seats by shareholder vote and SandRidge agreed to give him a fifth after another seat was too close to call.

two separate columns for the company nominees (one for company nominees not opposed by the Rice Group and the other for company nominees opposed by the Rice Group).¹⁰ EQT's universal proxy card included two columns for nominees, one for company nominees and one for Rice Group nominees.¹¹

Some practitioners believe that such differences in the presentation of information on the proxy card can cause shareholder confusion, and at least one commentator found the presentation of nominees on the Rice Group's universal proxy card inadequate because it did not present the nominees with equal prominence.¹²

4. Implementation concerns may have diminished. Companies have historically rejected dissidents' request to use a universal proxy for a variety of reasons, including:

- Use of a universal proxy card could create a "significant risk of confusion that could result in disenfranchisement of certain stockholders"¹³ and "deprive holders of the ability to simply sign and return voting forms without marking a preference;"¹⁴
- "[S]ufficient infrastructure does not yet exist to support the use of a universal proxy card;"¹⁵
- The "Board does not support experimenting with a new and untested voting process;"¹⁶
- "[E]xisting 'street name' voting infrastructure does not fully support universal proxy card voting, creating significant risk of confusion and delay that could result in disenfranchisement of retail holders;"¹⁷ and
- Implementation is impractical "due to a lack of a viable automated tabulation system."¹⁸

The recent use of universal proxies, including the first reciprocal use by parties in an election contest, may have alleviated some of these implementation-related concerns.

5. Observations from recent use of universal proxies may serve to validate the SEC's rationale for proposing a mandatory universal proxy system. In the Proposing Release, the SEC made clear that it carefully considered whether to mandate use of universal proxies or to allow each party to decide whether to use a universal proxy.

Ultimately, the SEC concluded that a mandatory rule would "more effectively address the problem of shareholders' inability to vote by proxy for the combination of nominees of their choice." In reaching that conclusion, the SEC indicated that it believed a mandatory system would prevent soliciting parties from selectively using universal proxies when it suits their strategic needs by applying the requirements uniformly to all soliciting parties and to all election contests.

The SEC also indicated that a mandatory system would mitigate potential shareholder confusion and logistical issues that may result from allowing the parties in a contested election to choose whether to use a universal proxy. Given these rationales, the SEC may be persuaded by observations from the recent use of universal proxies to adopt a mandatory system.

¹⁰ See Definitive Additional Materials on Schedule 14A filed by Toby Rice on May 30, 2019.

¹¹ See Definitive Proxy Statement on Schedule 14A filed by EQT Corporation on May 22, 2019.

¹² See Council of Institutional Investors, *Universal Proxy Cards*, available at https://www.cii.org/cii_universal_proxy.

¹³ See Definitive Proxy Statement on Schedule 14A filed by Destination Maternity Corporation on April 23, 2018.

¹⁴ See Soliciting Material on Schedule 14A filed by E. I. du Pont de Nemours and Company on March 3, 2015.

¹⁵ *Id.*

¹⁶ See Exhibit 1 to the Definitive Additional Materials on Schedule 14A filed by Automatic Data Processing Inc. on September 22, 2017.

¹⁷ *Id.*

¹⁸ See Definitive Additional Materials on Schedule 14A filed by Target Corporation on May 11, 2009.

Delaware Chancery Upholds Waiver of Appraisal Rights

By John Bradley, Partner, and David Rosenfield, Associate, of Troutman Sanders LLP

The Delaware Court of Chancery recently held that the Delaware General Corporation Law (DGCL) does not prevent sophisticated owners of a corporation from waiving statutory appraisal rights in advance as part of a negotiated agreement. *Manti Holdings, LLC, et al. v. Authentix Acquisition Company, Inc.*, C.A. No. 2017-0887-SG, 2019 WL 3814453 (Del. Ch. August 14, 2019).

Background and Prior Chancery Court Decision

In 2008, the stockholders of Authentix Acquisition Company, Inc. (“Authentix”) entered into a stockholder agreement as an inducement to a merger transaction. The stockholder agreement required the stockholders to consent to a future sale of the merged entity and refrain from exercising their statutory appraisal rights. The merged entity was later sold in a subsequent merger transaction with a third party.

The petitioners were common stockholders who had their shares converted to the right to receive only nominal cash consideration in the merger. The petitioners pursued a claim for statutory appraisal rights under DGCL Section 262. The Court denied the petitioners’ claim, ruling that they were contractually barred from asserting appraisal rights as the stockholders had voluntarily agreed to waive those rights under the stockholder agreement in return for consideration.

The prior case focused on interpretation of the stockholder agreement but did not expressly address whether a waiver of appraisal rights is valid under Delaware law. *Manti Holdings LLC v. Authentix Acquisition Co.*, C.A. No. 2017-0887-SG, 2018 WL 4698255 (Del. Ch. October 1, 2018). The petitioners led a Motion for Reargument, asserting that the DGCL does not permit an advance waiver of appraisal rights and that such a waiver would otherwise be inconsistent with Delaware law.

Permissibility of Appraisal Rights Waiver

The Court agreed to consider the motion on the basis that it had not explicitly ruled that the DGCL permits a stockholder, by contract, to waive appraisal rights in advance. The Court’s analysis in the present case focused on whether the DGCL forbids the sophisticated owners of a corporation from negotiating a term as part of a merger agreement that binds them to a future sale and waives statutory appraisal rights.

The petitioners argued that DGCL Section 262 is a mandatory provision, and that mandatory rights cannot be waived *ex ante*. The petitioners cited the Court’s decision in *Appraisal of Ford Holdings, Inc. Preferred Stock*, which stated that “generally . . . mandatory provisions may not be varied by the terms of the certificate of incorporation or otherwise.” The Court noted that *Ford Holdings* nevertheless upheld a contract that fixed the appraisal price of preferred stock, rendering statutory appraisal meaningless.

The Court further noted that appraisal rights are mandatory only in the sense that they exist for all stockholders of Delaware corporations by statute; however, they are not mandatory given that stockholders need not pursue appraisal, and an appraisal action need not proceed in every instance in which statutory appraisal is permitted under the DGCL. In addition, stockholders must meet certain procedural requirements to invoke appraisal rights, and stockholders are deemed to have waived appraisal rights if those requirements are not satisfied.

Petitioners also argued that a corporation may not impose an advance waiver of appraisal rights by separate agreement because, even if not clearly prohibited by the DGCL, an advance waiver of appraisal rights is nevertheless inconsistent with the DGCL. Petitioners pointed to a hierarchy, with DGCL at the top echelon, followed by a corporation’s certificate of incorporation, then its bylaws, and then other contracts, such as the stockholder agreement at issue in the present case.

The Court noted that the DGCL does not explicitly prohibit contractual modification or waiver of appraisal rights, nor does it require a party to exercise its statutory appraisal rights. Accordingly, such modification or waiver serves to supplement the DGCL, and is not inconsistent with, nor contrary to, the DGCL.

The Court applied the same logic to Authentix’s certificate of incorporation and its bylaws, which were silent regarding waiver of appraisal rights; moreover, as a contract between the corporation and its stockholders, the Court stated that the stockholder agreement augments the parties’ rights and responsibilities.

The Court held that given the reasoning in the *Ford Holdings* case, in light of Delaware’s precedent permitting waiver of other statutory rights, and in light of the specific facts of the present case, the waiver

of appraisal rights is permitted under Delaware law, as long as the relevant contractual provisions are clear and unambiguous.

The Chancery Court's Decision

The Court found that the stockholder agreement is a clear, unambiguous contract, created in connection with a merger, that was entered into by sophisticated parties, including the petitioners who owned the entire interest in the entity to be merged, and under which the petitioners obtained some rights and relinquished others, accepting the benefits of the agreement for many years. The Court did not decide whether a waiver of appraisal rights would be upheld in other circumstances.

The Court's decision provides clear authority that advance waivers of appraisal rights are permitted under Delaware law provided the relevant contractual provisions are clear and unambiguous. Practitioners and companies should ensure that waivers of appraisal rights are carefully drafted to avoid successful challenge on grounds of clarity and ambiguity.

Does Your Acquisition Agreement Trigger a Form 8-K?

By Kevin Douglas, a Partner of Bass Berry & Sims LLP

When a public company is contemplating an acquisition, lawyers should consider early in the acquisition process whether the execution of the acquisition agreement and/or the completion of the acquisition may trigger a filing under Item 1.01 or Item 2.01 of Form 8-K.

Item 1.01: Is Your Acquisition Agreement a "Material Definitive Agreement?"

Item 1.01 of Form 8-K requires disclosure when a registrant enters into a "material definitive agreement" outside of the ordinary course of business. In the context of an acquisition, this in most cases would potentially be triggered by the execution of the definitive acquisition agreement (rather than a letter of intent or term sheet).

The determination of whether the execution of a definitive acquisition agreement triggers Item 1.01 is a subjective determination based on general standards of materiality as defined in SEC rules, judicial decisions and administrative guidance (for example, the *Levinson* test that defines information as material if "there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision" by significantly altering the mix of information available).

There is a relative dearth of SEC authority on the subject of whether an acquisition agreement (or any agreement more generally) should be considered a material definitive agreement for purposes of Item 1.01. However, there are certain guideposts and considerations which an acquiring registrant should take into account when making a determination as to whether an acquisition agreement constitutes a material definitive agreement for purposes of Item 1.01.

Will the Deal Trigger an Item 2.01 Filing? A helpful first step in this analysis is whether the acquisition (when completed) will trigger Item 2.01 based on the bright-line quantitative tests thereunder (discussed below). If Item 2.01 of Form 8-K is triggered, then in most cases a registrant will determine that a Form 1.01 Form 8-K will be required in connection with the execution of the definitive agreement.

Other Materiality Indicators if Item 2.01 Is Not Triggered. If an acquisition is significant to a registrant but Item 2.01 is not triggered, then the registrant may have a challenging judgment as to whether the acquisition agreement should trigger a filing under Item 1.01 of Form 8-K. In this regard, relevant factors may include:

- Key income statement metrics of the acquired business compared to the registrant (which may include revenue, operating income, net income and EBITDA)
- The book value of the assets of the acquired business compared to the registrant

- The purchase price paid by the registrant in comparison to the book value of the registrant’s assets
- The purchase price paid by the registrant in comparison to the enterprise value and/or market cap of the registrant
- Whether the acquisition would result in a significant increase in the debt leverage of the registrant and/or would require additional debt or equity financing sources
- Whether the acquired business would give rise to a new product or business line or reporting segment of the registrant or otherwise further any key strategic initiatives or goals of the registrant
- Whether the registrant is particularly acquisitive (if this is the case, this may somewhat move the needle against Item 1.01 being triggered in connection with any particular acquisition)
- Whether any members of the management team of the target company will become executive officers or directors of the registrant
- Whether there are other obligations or benefits (including under ancillary agreements) material to the registrant related to the acquisition
- The past practice of the registrant with respect to whether it has filed acquisition agreements under Item 1.01 (if a similar past acquisition of a registrant has triggered an Item 1.01 filing, this may support the decision to similarly file a subsequent similar acquisition)

With respect to the income statement, assets, and purchase price comparisons referenced in the first three bullets above, a rule of thumb used by some practitioners is that if one or more of these comparisons exceeds 5% or 10% (there are differing views as to which threshold is appropriate, with 5% being more conservative), this may be viewed as an indicia of materiality (recognizing that qualitative factors are also relevant).

If Item 1.01 is triggered, then the registrant will be required to file a Form 8-K setting forth certain information regarding the acquisition agreement (including the material terms and conditions of the agreement) within four business days following the execution of the agreement. In addition, the registrant will be required file the agreement, either as an exhibit to the Form 8-K or as an exhibit to the periodic report covering the period in which the agreement is entered into.

Item 2.01: Does Your Deal Involve a “Significant Amount of Assets”?

Item 2.01 of Form 8-K provides that, when a registrant has completed the acquisition of a significant amount of assets, other than in the ordinary course of business, the registrant will be required to file a Form 8-K and disclose certain information regarding the acquisition within four business days following the completion of the acquisition. Unlike Item 1.01, the determination of whether the completion of an acquisition triggers Item 2.01 is based on bright-line quantitative tests.

Assuming that an acquisition involves the acquisition of a business, under clause (ii) of Instruction 4. of Form 8-K and Item 11-01(b) of Regulation S-X, an acquisition is significant if one of the three significance tests under Rule 1-02(w) of Regulation S-X is tripped at the 20% level.

It is beyond the scope of this article to address the significant subsidiary tests under Rule 1-02(w) of Regulation S-X and the associated financial statement filing requirements under Form 8-K, which can be quite complicated. However, at a high level, under Rule 1-02(w) of Regulation S-X, the three tests compare (1) the target company’s assets vs. the registrant’s assets, (2) the purchase price of the acquisition vs. the registrant’s assets, and (3) the target company’s income from continuing operations before income taxes (the “pre-tax income”) vs. the pre-tax income of the registrant (the measuring period for these determinations for the registrant is generally the prior fiscal year of the registrant).

If any of these three tests is tripped at the 20% level, a Form 8-K under Item 2.01 is triggered, and the filing of financial statements is required.

If the filing of financial statements is required as noted above, the registrant is generally required to file (1) pro forma financial information reflecting the acquisition for the prior fiscal year plus any interim period, and (2) historical annual audited financial statements of the target company for one, two or three years, depending on the significance level of the acquisition (whether 20%, 40% or 50%) and other considerations.

With respect to acquisitions, the deadline for filing required financials (via a Form 8-K/A) is 71 calendar days following the original due date for the 8-K.

Practical Consequences of Triggering a Form 8-K in an Acquisition

The issue of whether an acquisition will trigger an 8-K filing can have a significant impact on the acquisition negotiation and process, including in relation to the following:

- If a determination is made that an acquisition agreement will need to be filed, the acquiring registrant (if a regular acquirer) may have reticence about agreeing to certain deal terms in a publicly-filed agreement which may be used against the registrant in connection with future M&A activity. In this regard, it is not uncommon for M&A lawyers to use publicly-filed acquisition agreement precedent against the registrant in future deal negotiations.
- If a determination is made that an acquisition agreement will need to be filed, the parties will need to consider whether there are confidential or sensitive terms included in the agreement from the perspective of one or both parties (e.g., the parties may be concerned that the existence of a specific indemnity could give rise to an inference or a presumption from the perspective of a plaintiff or a governmental authority that a legal violation has occurred or there otherwise is substantive monetary exposure).
- Taking into account the considerations noted in the first two bullets above, the parties will want to consider whether the registrant intends to file any schedules, annexes or exhibits associated with the acquisition agreement (the recent FAST Act amendments provide that a registrant will no longer have to file schedules or attachments to material contracts unless they contain material information not otherwise disclosed in the contract).
- If Item 2.01 of Form 8-K is triggered such that audited financial statements of the target company will need to be filed by the registrant following the closing, an acquiring registrant may insist that the audited financials be completed before the signing of the definitive acquisition agreement or at least require that such audited financials be completed as a condition to closing.
- In acquisitions with a gap between signing and closing, the determination that the acquisition agreement triggers Item 1.01 (which will require a filing within four business days following *execution* of the acquisition agreement) may result in public disclosure of the acquisition earlier than the target company and/or the acquirer desire (for example, the target company may not want the customers, suppliers, employee base, etc. of the target company to be aware of the acquisition until after the *closing* has occurred).

Disclosure of Projections: Will Delaware's Approach Still Rule the Roost?

By John Jenkins, Editor, DealLawyers.com¹

The nature and extent of a company's obligation to disclose financial projections when soliciting shareholder approval of an M&A transaction is a particularly complex area. These forecasts may be provided to a variety of parties, including financial advisors, the board of directors, and the buyer and its representatives, and management's projections often play a pivotal role in the M&A valuation process and in the analyses underlying investment bankers' fairness opinions.

Projections raise disclosure issues under both the federal securities laws and state corporate law. At the federal level, the SEC's Division of Corporation Finance has a relatively straightforward approach to the issue, typically calling for disclosure of projections that the target provided to the acquirer and other bidders.

While the Staff's review process generally provides it with significant leverage to require disclosure of projections, it has historically been the Delaware courts where the issue of materiality of M&A projections has been addressed head-on. That reflects Delaware's historic status as the preferred venue for M&A litigation.

Today, Delaware's dominance in M&A objection litigation appears to be a thing of the past, with litigation migrating toward the federal courts following the Delaware Chancery Court's 2016 *Trulia* decision that

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imposed strict limits on disclosure-only settlements.² But does that mean Delaware’s jurisprudence concerning the materiality of projections will be supplanted by precedent under the federal securities laws?

If so, then plaintiffs may be in for some tough sledding, because—surprisingly—the federal securities laws do not have a wealth of precedent to draw upon addressing disclosure of M&A projections. Furthermore, despite the Staff’s position on disclosure, most federal courts have traditionally been reluctant to find “soft information,” such as projections, to be material for purposes of the federal securities laws.³

However, there is reason to believe that Delaware’s approach to the materiality of projections and various issues surrounding the extent to which they need to be disclosed as a matter of directors’ fiduciary duty may remain influential to federal courts that will be called upon most frequently to interpret the requirements of the federal securities laws in the context of merger objection litigation.

This article will review Delaware’s approach to the materiality of projections and suggest some reasons why that approach may prove to be influential to federal courts dealing with projection disclosure claims under the federal securities laws.

The SEC Staff’s Position on Disclosure of Financial Projections

Before moving on to Delaware, it is useful to spend a few minutes discussing the Staff of the Division of Corporation Finance’s position—because its position virtually ensures that public company M&A disclosure documents will include some financial projections.

The Staff’s position has generally been that projections provided by the target to the acquirer are likely material and should be disclosed to the target’s shareholders.⁴ In addition, Item 1015(b)(6) of Regulation M-A requires disclosure of “the bases for and methods of arriving at” the findings and recommendations contained in an investment bank’s fairness opinion, thus resulting in a frequent comment from Staff reviewers for disclosure of projections furnished to the bank in connection with the preparation of its opinion.⁵

Reflecting the Staff’s position, most public company M&A disclosure documents include a section addressing the forecasts provided to the board and the company’s financial advisors in connection with their evaluation of the transaction.

Delaware’s Facts & Circumstances Approach to Financial Forecasts

The Staff of the SEC’s Division of Corporation Finance has taken a relatively straightforward approach to the disclosure of projections. But it—and the federal courts—have not done a lot of the heavy lifting concerning issues surrounding what financial projections may be material and the extent of the disclosure required. That burden has fallen on Delaware’s shoulders.

Delaware courts have also generally endorsed the view that financial projections prepared by management and shared with the target’s financial advisor must, as a matter of Delaware fiduciary law, be disclosed to the shareholders.⁶ But just how extensive that disclosure needs to be in connection with a merger is more uncertain. Delaware courts have spent a lot of time on this issue, but it’s a topic on which their decisions have shed at least as much heat as light.

“Exhibit A” for the uncertainties associated with Delaware’s approach to disclosure of projections is a pair of Delaware Supreme Court decisions issued less than a year apart. In its 2000 decision in *Skeen v. Jo-Ann Stores*, the Delaware Supreme Court rejected plaintiffs’ efforts to obtain additional detail about bankers’ fairness opinion analyses and disclosure of five years of management projections.⁷

The Court concluded that even though investment bankers’ analyses might well be “helpful” to shareholders in determining whether to vote in favor of a transaction or exercise appraisal rights, this type of information

² *In re Trulia Shareholders Litigation*, 129 A.3d 884 (Del. Ch. 2016) According to Cornerstone Research, only 13% of merger objection litigation for Delaware corporations was filed in the Chancery Court last year. Cornerstone Research, *Shareholder Litigation Involving Acquisitions of Public Companies*, (Sept. 2019) at 5.

³ For a review of federal decisions regarding the materiality of projections, see Dale Oesterle, *The Overused and Under-Defined Notion of “Material” in Securities Law*, 14 U. Pa. Bus. L. Rev. 167 (2011)

⁴ Thomas Cole, *Projections in Public Company M&A*, 9 Deal Lawyers 6 at pg. 1 (Nov.-Dec. 2015)

⁵ See Nick Grabar, Ethan Klingsberg, Sandra Flow and Meredith Kotler, *Setting the Record Straight: Regulation G Doesn’t Apply to M&A Forecasts*, 11 Deal Lawyers 6, at pg. 1 (Nov.-Dec. 2017)

⁶ Cole at pg. 5.

⁷ *Skeen v. Jo-Ann Stores*, 750 A.2d 1170 (Del. 2000)

is not “material” as a matter of law.⁸ In contrast, in a case decided later in that same year, the Supreme Court indicated that “the information provided to [the investment banker] and the valuation methodologies used by [the investment banker]” might well be material.⁹

In his 2002 *Pure Resources* decision, then-Vice Chancellor Leo Strine subsequently noted Delaware’s ambivalence in this area and said that “it is time that this ambivalence be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely.”¹⁰

Vice Chancellor Strine’s view in *Pure Resources* that shareholders are entitled to a “fair summary” of the investment banker’s work seems to have been generally accepted by the Chancery Court, but what a “fair summary” requires in terms of disclosure about projections is an issue that the judges have really struggled to resolve. Their struggles are reflected in a series of opinions that involve a lot of hair-splitting and not much in the way of useful guidance.

Even after *Pure Resources*, significant uncertainties remained about the nature and extent of the obligation to disclose projections. In 2007, two cases addressed fairness opinion disclosures, *In re Netsmart Technologies Shareholders Litigation*¹¹ and *In re CheckFree Corporation Shareholders Litigation*,¹² and reached markedly different conclusions concerning the need to disclose financial projections.

In *Netsmart*, the Court found that because the discounted cash flow valuation prepared by the seller’s investment banker was based on projections for the years between 2007 and 2011, the projections for all such years were material, and it was improper to omit information for 2010 and 2011 from the proxy statement. Although that information was not provided to potential bidders, the court held that it was material to shareholders because the Netsmart stockholders were presented with the banker’s fairness opinion and were being asked to vote on the merger.

In contrast, the *Checkfree* Court concluded that disclosure of management projections shared with investment bankers was not only not required but was potentially misleading:

[T]he proxy never purports to disclose these projections and in fact explicitly warns that Goldman had to interview members of senior management to ascertain the risks that threatened the accuracy of those projections. One must reasonably infer, therefore, that the projections given to Goldman did not take those risks into account on their own. These raw, admittedly incomplete projections are not material and may, in fact, be misleading.¹³

Recurring Projections Disclosure Issues

Subsequent cases in which disclosure of projections were an issue have continued this see-saw pattern, in which the outcome of each claim is highly fact-specific. Despite the unpredictable nature of their outcome, these cases come down to an assessment of the materiality of undisclosed projections.

M&A projections cases tend to involve a handful of recurring issues—disclosure of multiple sets of projections, disclosure of free cash flow, and the impact of the transaction structure on the disclosure obligation.

Multiple Sets of Projections. It is fairly common to see multiple sets of projections generated during the course of an M&A transaction. Often, the projections initially shared with potential buyers are fairly aggressive “puff pieces.” In other settings, projections may be updated to reflect changes in the business during the course of the transactions, or the board may be provided with “best case,” “base case,” and “bank case” projections reflecting different potential ranges of performance.

Delaware courts recognize that all of these multiple sets of projections aren’t per se material, and instead tend to focus on their reliability and whether the board or its financial advisors actually relied upon

⁸ *Id.* at 1174.

⁹ *McMullin v. Beran*, 765 A.2d 910 (Del. 2000).

¹⁰ *In re: Pure Resources, Inc. Shareholders Litigation*, C.A. No. 19876 (Del. Ch.; October 2002).

¹¹ *In re Netsmart Technologies S’holders Litig.*, 924 A.2d 171 (Del. Ch. 2007)

¹² *In re Checkfree Corp. S’holders Litig.*, C.A. No. 3193-CC (Del. Ch. Nov. 1, 2007)

¹³ *Id.*

them.¹⁴ In doing so, they often provide wide latitude to boards and their advisors in determining which projections were appropriate to rely upon and to disclose to shareholders.¹⁵ In some instances, Delaware courts have decided that projections were insufficiently reliable to require their disclosure—even in cases where they had been presented to the target’s board of directors.¹⁶

But in other cases, Delaware courts have been less deferential to decisions not to disclose multiple sets of projections. For example, a recent Chancery Court decision held that disclosure of projections that reflected a downward adjustment to prior projections made after the board approved the final deal price was insufficient, and that the company should have disclosed both the more optimistic prior version of the projections and the reasons for the downward adjustment.¹⁷

Free Cash Flow Projections. Another recurring issue relating to projections is the need to disclose assumptions about free cash flow made in connection with fairness opinions. These are often targeted by plaintiffs, because those assumptions form the foundation for any discounted cash flow analysis—and changes in them can result in dramatically different valuations.

Delaware case law on this issue has been characterized as standing for the proposition that if a DCF analysis is used as part of the financial advisor’s fairness opinion, disclosure of the free cash flow assumptions “will often, but not always, be required.”¹⁸

The identity of the party preparing the free cash flow projections is often a critical factor. Some Delaware courts have treated management’s free cash flow projections as virtually per se material.¹⁹ Other courts have held that free cash flow projections prepared by the company’s financial advisor were not material and need not be disclosed.²⁰

While some Chancery decisions indicate the free cash flow projections are per se material, other decisions indicate that disclosure of free cash flow projections may not be required under some circumstances. In his bench ruling in *Cox v. Guzy*, then-Vice Chancellor Strine held that if other forecasts were disclosed, the target had negligible debt and the free-cash flow proxy EBITDA could be calculated based on the publicly disclosed forecasts, further disclosure regarding projected free cash flow was unnecessary.²¹

Impact of Different Transaction Structures. Delaware case law also suggests that in evaluating the materiality of projections, the structure of the deal is also an important consideration:

The materiality of projections is heightened in cash-out merger transactions, where the stockholders are being asked to evaluate whether to accept the merger consideration or to continue as stockholders of the corporation. The materiality of projections is heightened uniquely in going private transactions, and particularly where “key managers seek to remain as executives and will receive options in the company once it goes private.”²²

While most Delaware litigation has focused on issues surrounding the seller’s projections, that is not always the case. In certain stock-for-stock transactions, Delaware courts have also held that the buyer’s projections may be material to the seller’s shareholders and should be disclosed.²³

¹⁴ See, e.g., *Frank v. Elgamal et. al.*, C.A. No. 6120-VCN (Del. Ch. Mar. 10, 2014) (“American Surgical only disclosed the updated midpoint case projections, but these projections were the only ones relied upon by HFBE when it delivered its second and then final fairness opinion presentations in December 2010.”)

¹⁵ See, e.g., *In re Orchid Cellmark Inc. Shareholder Litigation* C.A. No. 6373-VCN (Del. Ch. May 12, 2011) (“[i]n evaluating the fairness and advisability of this tender offer, the Special Committee and its financial advisor [were] not precluded from considering various sets of financial projections before determining that one set reflect[ed] the best estimate of future performance.”)

¹⁶ *In re BEA Systems, Inc. Shareholder Litig.*, C.A. 3298, Lamb, V.C. (Del. Ch. Mar. 26, 2008) (Transcript) (“the fact that something is included in materials that are presented to a board of directors does not, ipso facto, make that something material.”)

¹⁷ *Chester County Employees’ Retirement Fund v. KCG Holdings, Inc.*, C.A. No. 2017-0421-KSJM (Del. Ch. June 21, 2019).

¹⁸ Krishna Veeraraghavan and Scott Crofton, *Financial Projection Disclosure Requirements in M&A Deals: Preparing, Using and Disclosing Projections*, July 2016 at 26. <http://media.straftfordpub.com/products/financial-projection-disclosure-requirements-in-manda-deals-preparing-using-and-disclosing-projections-2016-07-20/presentation.pdf>

¹⁹ *Maric Capital Masterfund, Ltd. v. Plato Learning, Inc.*, 11 A.3d 1175, 1178 (Del. Ch. 2010) “[I]n my view, management’s best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information.”

²⁰ See, e.g., *In re BioClinica, Inc. Shareholder Litigation*, C.A. No. 8272-VCG (Del. Ch. Oct. 16, 2013); *Nguyen v. Barrett*, CA No. 11511-VCG, 2015 WL 5882709 at *4 (Del. Ch. Oct. 8, 2015).

²¹ *Veeeraraghavan & Crofton* at 28, citing *Cox v. Guzy*, C.A. 7529-CS (Del. Ch. June 8, 2012) (Transcript)

²² Michael Tumas and Michael Reilly, *The Disclosure of Projections Under Delaware Law*, Potter Anderson & Corroon LLP Client Memo, (April 2008). http://www.potteranderson.com/media/publication/155_TheDisclosureofProjectionsUnderDelawareLaw.pdf

²³ *In re S1 Corp. Shareholders Litig.*, Consolidated C.A. No. 6771VCP (Del. Ch. Aug. 19, 2011)

How Did Delaware Get Here?

Unfortunately, as the foregoing discussion suggests, the Delaware courts have focused on the materiality of projections and have looked at their place in the total mix of information provided to shareholders. That has necessarily resulted in a messy, ad hoc approach to evaluating disclosure requirements with respect to projections, and that approach is unlikely to change.

That means M&A lawyers are likely to struggle with very murky guidance on this topic for quite some time—which raises a question: since the federal courts appear to have largely punted on this issue, if the federal courts have largely punted on this issue, why did Delaware wade into it?

The answer to that question goes back to the mid-1980s, and specifically to a case called *Weinberger v. Rio Grande Industries*.²⁴ In that case, the Chancery Court adopted the Third Circuit's test for determining whether projections need to be disclosed.

In *Flynn v. Bass Brothers*, the Third Circuit held that for purposes of the federal securities laws, the existence of a duty to disclose projections should be determined on a case-by-case basis “by weighing the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note.”²⁵

The *Flynn* court's take on disclosure of projections represents a minority position among federal circuit courts. Most appellate courts that have addressed the issue take the position that the federal securities laws do not impose an obligation upon an issuer to disclose projections.²⁶

The Sixth Circuit, which probably continues to reflect the view of most circuit courts that have addressed the issue, has criticized the Third Circuit's standard, noting that it is an “uncertain and unpredictable judicial cost-benefit analysis.” In the Sixth Circuit, soft information is only required to be disclosed if it is “virtually as certain as hard facts.”²⁷

The approach of federal courts outside the Third Circuit to the materiality of projections has been the subject of criticism by commentators:

The reasoning of the federal courts surrounding the materiality of projections has been sloppy, perhaps by design. The courts, once a projection is on the table, fail to separate the projection itself from, first, the facts that are the basis of the projection and, second, the important fact that a company's managers are relying on the projections. . . .

A few courts do draw the distinction. Most often, however, courts anxious to declare projections to be not material throw out every fact associated with the projection as well as the projection itself. One could write this off as carelessness or, on the other hand, as carefully intended judicial convenience and efficiency.²⁸

There are a number of nuances that can result in exceptions to the “majority view” among federal courts that disclosure of projections is not required. More importantly, as previously noted, the SEC Staff will frequently push for disclosure of information about projections if it is not contained in a summary of the fairness opinion including in a merger proxy statement.²⁹

Nevertheless, by adopting the Third Circuit's position as the starting point, the nation's most influential state corporate law court has adopted what has historically been the least influential federal approach to the issue of disclosure of soft information, and the consequences of that decision for M&A litigation have been far reaching.

In fact, it seems fair to say that adoption of the facts and circumstances-based *Flynn* standard made the subsequent unpredictability of Delaware's case law on projections almost inevitable. What's more,

²⁴ *Weinberger v. Rio Grande Indus., Inc.*, 519 A.2d 116 (Del. Ch. 1986)

²⁵ *Flynn v. Bass Brothers*, 744 F.2d 978, 988 (3d Cir 1984)

²⁶ See, e.g., *Glassman v. Computervision*, 90 F.3d 617, 631 (1st Cir. 1996).

²⁷ *Starkman v. Marathon*, 772 F.2d 231 (6th Cir. 1985). In *Helwig v. Vencor*, 251 F.3d 540, 558 (6th Cir. 2001) the Sixth Circuit modified this standard by holding that while earnings forecasts may not have been material in isolation due to their uncertainty may become under the *Basic v. Levinson* standard “if information about them is stated falsely or misleadingly in [other] communications.”

²⁸ *Oesterle* at 198 (2011)

²⁹ As a result of the Sixth Circuit's position in *Vencor* concerning the ability of false or misleading statements surrounding them to transform otherwise immaterial projections into actionable misstatements or omissions, mandating the inclusion of those projections may help plaintiffs to frame disclosure claims in a manner that overcomes the reluctance of federal courts to find those statements material.

adoption of that standard also guaranteed that there would be plenty of cases in which disclosure of projections would be at issue.

In order to understand why both of these outcomes were likely, you need to appreciate that the advantages that disclosure litigation in Delaware traditionally provided to plaintiffs. The business judgment rule does not protect against disclosure claims, because a decision about disclosure is not “a decision concerning the management of the business and affairs of the enterprise.”³⁰ In the past, disclosure claims also have proven to be an effective way for plaintiffs to obtain an injunction against a pending merger transaction, which maximizes their potential leverage in negotiating a settlement.³¹

When you add *Flynn’s* plaintiff-friendly disclosure standard into the mix with the existing advantages of disclosure litigation, you can see why disclosure of projections have been raised as an issue in so many M&A cases filed in the Delaware Chancery Court. While the Delaware courts’ decision in recent years to take a much harder line on disclosure only settlements may have curbed pure disclosure-based litigation, disclosure is still a factor in Delaware litigation—and plaintiffs continue to challenge the adequacy of disclosures surrounding projections in order to avoid the application of Delaware’s *Corwin* doctrine to breach of fiduciary duty claims.³²

Perhaps the more important question, however, is what the impact of Delaware’s case law will be on the underdeveloped federal jurisprudence in this area? While most M&A objection lawsuits in federal court are typically styled as securities law class actions and allege disclosure violations, in order to avoid the application of Delaware exclusive forum clauses, many of these lawsuits do not allege state law fiduciary duty of disclosure violations.

However, the Third Circuit has become by far the preferred venue for federal M&A objection lawsuits, accounting for nearly 70% of the suits filed in the first half of 2019.³³ Since Delaware borrowed its approach to materiality of soft information from the Third Circuit, it will be interesting to observe the extent to which courts in the Third Circuit look to Chancery Court decisions to inform their analysis of materiality of projections under the federal securities laws.

Federal courts are not accustomed to looking to state court decisions to inform their understanding of the requirements of federal law, but there are reasons to believe that courts in the Third Circuit may be more amenable to this approach here.

- First, they are dealing with a specific issue as to which there is a noticeable absence of federal authority.
- Second, the Delaware courts have evaluated materiality of M&A projections under the same standard as has been applied by the Third Circuit in its evaluation of the materiality of soft information.
- Third, Delaware’s fiduciary duty of disclosure approaches the general concept of materiality under the same “reasonable investor” standard adopted by the Supreme Court under the federal securities laws.
- Finally, the Delaware Court of Chancery is recognized as having a high level of sophistication and expertise in dealing with disclosure issues surrounding complex corporate transactions.

For these reasons, it seems fair to at least suggest that while the Delaware Court of Chancery may no longer be the preferred venue for most M&A objection litigation, its precedent addressing these issues under state law fiduciary duty standards may prove influential to the federal courts most likely to be called upon to flesh out what is required with respect to these matters under the federal securities laws.

³⁰ *In re Anderson, Clayton S’holders Litig.*, 519 A.2d 669 (Del. Ch. 1986).

³¹ In recent years, disclosure litigation in Delaware has declined precipitously, due to the high bar that courts have set for “disclosure-only” settlements.

³² See, e.g., *Morrison v. Berry*, No. 445 (Del., July 27, 2018) (Though Plaintiff challenges the adequacy of other disclosures, such as those concerning the management projections reviewed by the Board, we need not consider them here given that the aforementioned deficiencies in the disclosures prove sufficient to deny *Corwin* “cleansing”).

³³ Cornerstone Research, *Securities Class Action Filings: 2019 Mid-year Assessment*, (July 2019) at 10.

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